

CHAPTER 1

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1.1 OBJECTIVE OF STUDY

Inflation risk has always been of great importance and concern for investors who hold assets for long term returns. This is because in times of inflation, when the purchasing power of money is rapidly decreasing, it is not only important that the capital which was originally invested should be capable of being recouped at any point in time, but also that the investment in which the money has been placed appreciates at a sufficiently rapid rate to keep pace with the changing value of money. Assets that are inflation-hedgers provide protection against the risk of losing the purchasing power and as such appear to be more attractive to investors than those that are not.

There is limited empirical evidence published on the inflation hedging characteristics of real estate or property returns and financial assets in Malaysia. This has prompted the main purpose of this dissertation, which is to examine the extent and effectiveness of property returns and property stock returns in hedging inflation in Malaysia.

1.2 SIGNIFICANCE OF STUDY

Historically, property has been regarded as one of the best inflation hedges. Property being limited and inelastic in supply is believed to appreciate in value

with time. As such, property has been accepted as an attractive alternative to other forms of investment such as stocks, bonds and even treasury bills.

This study will examine the effectiveness of property investment in hedging inflation in Malaysia. The study will also be extended to the property stock market to examine if it has a similar behaviour pattern as that of property.

1.2.1 INVESTMENT

Investment risk and potential reward often go hand in hand as the greater the risk, the greater the reward potential. Alternatively, the lower the risk, the lower the return is likely to be. Hence different types of investment albeit; stocks, bonds, property or real estate, fixed deposits, treasury bills, etc. carry different risk return ratios.

Investors consider various factors before choosing an investment vehicle. These include the security of capital, security of income, the regularity of income, ease of purchase and sale, transaction costs, divisibility of holdings, security in real terms and capital appreciation³ prospects. When an investment is secure in real terms⁴ it is often referred to as being a good hedge against inflation, or as being inflation-proof. More often than not, the inflation hedging ability of the investment is only considered when the investment is on a long term basis.

1.2.2 INVESTMENT IN PROPERTY

For the general investor, property in particular the housing market represents one of the safest and most predictable forms of investment over the medium and long term. An investment in property is a big commitment and it typically involves a large outlay of cash and is also relatively illiquid than other investments. However, property is viewed as a better investment than equities because property price fluctuation is usually less volatile.

Property is an investment that investors can hold on to for a lifetime or sell for a profit when it has appreciated to one's satisfaction. Generally property prices will appreciate in value; probably slowly during a sluggish economy but definitely quite substantially in a robust and healthy economy.

1.2.3 INVESTMENT IN STOCKS

Of all the investment vehicles available, stocks generate the most interest because they yield the highest rate of return, but they also carry the highest risk. Stocks provide investors with much greater liquidity, diversification and risk benefits and an ability to invest at a much lower cost. The volatile nature of stock prices makes it possible for fortunes to be made and destroyed literally overnight. However when held on for long term gains, the short term volatility will not have dire consequences.

1.3 SCOPE OF STUDY

The study will be conducted based on data available on the Malaysian House Price Index (MHPI) and its sub-indices, Kuala Lumpur Stock Exchange's (KLSE) Kuala Lumpur Property Stock Index (KLPI), the Consumer Price Index (CPI) and the Treasury Bills (T-Bills).

The KLPI is based on the relative stocks, which are listed on the main board of the Kuala Lumpur Stock Exchange. Data on the KLPI are obtained from the monthly issues of the Investors Digest published by the KLSE. The T-Bill rates are obtained from the monthly and quarterly Statistical Bulletins, the Annual Reports published by Bank Negara Malaysia and the Finance Ministry's annual Economic Reports. The MHPI and its sub-indices are obtained from the annual and semi-annual publications of 'The Malaysian House Price Index' published by the Valuation and Property Services Department, Ministry of Finance Malaysia, whilst the CPI is available from the Department of Statistics Malaysia. The MHPI is the closest proxy for benchmarking property performance in Malaysia.

The indices are computed to calculate the continuously compounded change, rate or nominal returns. The time series of the nominal returns of the MHPI and the KLPI are then tabulated and regressed against inflation (based on the Malaysian CPI), in order to analyze the relationship and significance of their respective returns over a period of time in relation to inflation.

Due to the unavailability of more frequent data on the MHPI, the study will focus on all the variables on a year-end basis from 1988 until 2001 (i.e. a period of 14 years). This is done for purposes of consistency in data comparison.

1.4 LIMITATIONS OF STUDY

Currently there is an absence of time-series data on all property, commercial and industrial property in Malaysia. The lack of data on property performance measures hampers all related analysis with regard to direct commercial and industrial property investments. Due to the infrequent data on the MHPI, the analysis comparing investment in property (housing) with other indices is limited to an annual comparison. As such the volatility exhibited by the MHPI is constrained.

The criteria of property companies that are listed on the KLSE amongst others include; a minimum land bank of 405 hectares, and have sufficient ongoing property development projects to be able to sustain reasonable earnings for at least five years after listing. However most of these companies have well diversified activities although they predominantly qualify under the properties counter of the KLSE. Hence their performance is not entirely linked to property earnings.

There are property investment companies in Malaysia in the form of listed property trusts. Property trusts invest in real property such as retail and

commercial/office properties and provide the investor with an opportunity to gain exposure to the property market in a way, which is impossible for the small investor. Returns from property trusts are generated from the rental income from the property plus any capital appreciation that comes from holding the property over the period. At the moment there are only three listed property trusts in Malaysia and there are no indices available to gauge their performance over the years. Hence this research does not take property trusts into account and limits to the properties index of the KLSE.

1.5 ORGANIZATION OF STUDY

This paper is organized in the next five chapters as follows. Chapter 2 gives an overview of the property market and describes the inflation scenario in Malaysia over the last fourteen years, i.e. from 1988 until 2001. Chapter 3 presents the literature review on the subject and particularly of inflation hedging characteristics of property and property stock in several countries. The research methodology is discussed in Chapter 4 together with description of the data used for analysis. Chapter 5 presents the summary of statistical analysis and results of the research. Finally, Chapter 6 concludes the paper with findings, implications and suggestions for future research.